

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Poochigian Analyst: Kimberly Pantoja Bill Number: SB 719  
Related Bills: See Legislative History Telephone: 845-4786 Introduced Date: 02/23/2001  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Health Insurance Costs Paid for Family Member Refundable Credit

### SUMMARY

This bill would create a refundable tax credit for health insurance paid by a taxpayer for any member of the taxpayer's family that is eligible to receive benefits under the Healthy Families Program.

### PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to establish a market-based insurance program for families that ensures that California maintains federal funding for the Healthy Families Program.

### EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective upon enactment. The credit would be operative for taxable years beginning on or after January 1, 2001, and before January 1, 2008.

### POSITION

Pending.

#### Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the implementation concerns discussed below.

### ANALYSIS

#### FEDERAL/STATE LAW

Current state and federal laws allow self-employed individuals to deduct a certain percentage of the cost of health insurance from gross income in determining adjusted gross income (AGI). This current deductible percentage is 60%. Under both federal and state laws, the deduction from gross income is not allowed if the individual or individual's spouse is eligible to participate in any subsidized health plan of any employer of the individual or individual's spouse.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Alan Hunter for GHG

04/19/2001

Under federal and state laws, a taxpayer may deduct medical expenses that are not reimbursed by insurance or otherwise for medical care of the taxpayer, his or her spouse, or a dependent to the extent that these expenses exceed 7.5% of the taxpayer's AGI. Medical expenses include amounts paid for diagnosis, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. Medical care also includes each of the following costs: certain travel and lodging to obtain medical care, accident and health insurance, eligible long-term care insurance, and prescription drugs. Health insurance that is not deductible as an adjustment to gross income because of the deductible percentage or other limitations may be included with itemized deductions as a medical expense.

Federal and state laws also provide that gross income does not include amounts attributable to the reimbursement of a medical expense of the taxpayer, spouse, or any dependents as long as the medical expense was not deducted in any taxable year.

Under both federal and state laws, the deduction of medical expenses or the exclusion from gross income discussed above applies to medical care and health insurance provided to the individual taxpayer, the taxpayer's spouse, and their dependents.

Under federal and state laws, individuals with income less than the filing thresholds are not required to file an income tax return since the standard deduction and personal exemption would eliminate any tax liability.

For 2000, the state filing thresholds are \$11,302 in gross income or \$9,042 in AGI for single taxpayers and \$22,605 in gross income or \$18,084 in AGI for married filing joint taxpayers. These thresholds are increased based on the number of dependents (e.g., for married filing joint with two dependents the threshold is \$36,313 in gross income). These thresholds are indexed annually for inflation.

### THIS BILL

Under the Personal Income Tax Law (PITL), this bill would create a refundable tax credit for the costs the taxpayer pays for health insurance for any member of the taxpayer's family as specified. The costs would be limited to an "eligible amount" as defined below. The taxpayer's family member(s) would be required to be eligible to receive benefits under the Healthy Families Program.

The bill defines "eligible amount" as an amount equal to the amount of the average benefit received during the year preceding the taxable year by a participant in the Healthy Families Program. "Healthy Families Program" is the program set forth under the Insurance Code.

The bill specifies this credit would be in lieu of any benefits for which the taxpayer's family is eligible under the Healthy Families Program.

This bill specifies that any credit in excess of the taxpayer's tax liability would first be credited against other amounts due, and the balance, upon appropriation by the Legislature, would be refunded to the taxpayer. The refunds must be paid during the taxable year on a quarterly basis through an application procedure and forms as prescribed by the Franchise Tax Board (FTB).

The bill specifies it is the intent of the Legislature to appropriate, for purposes of this refundable credit, an amount equal to any projected, unspent funds for the Healthy Families Program.

This bill requires the Legislative Analyst's Office to report annually to the Legislature on the health care provided to individuals in connection with this tax credit compared to the care provided by the Healthy Families Program.

## **HEALTHY FAMILIES PROGRAM BACKGROUND**

The Healthy Families Program is a state and federally funded program that provides low cost health, dental, and vision insurance coverage to children who do not have insurance and do not qualify for no-cost Medi-Cal.

California implemented the Healthy Families Program on July 1, 1998. Initially, coverage was limited to uninsured children with family incomes above Medi-Cal levels and below 200% of the federal poverty level (FPL). In November of 1999, eligibility for the Healthy Families Program was expanded to 250% of the FPL (\$35,376 for a family of three).

The success of the Healthy Families Program relies on the efforts of participating community-based organizations/programs, health care providers, clinics, schools, and insurance agents. Thus, the State of California recognizes the need to enhance enrollment incentives for organizations and subscriber families, and is continually introducing new program benefits.

## **IMPLEMENTATION CONSIDERATIONS**

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The bill specifies the credit would be for health insurance paid or incurred for any member of the taxpayer's family. "Any member" could be interpreted to mean any relation, no matter how distant, including those living in other cities or states. Limiting the credit to the taxpayer's dependents would ease administration and verification of the credit.

The bill specifies that the member of the taxpayer's family for whom health insurance is provided must be eligible to receive benefits under the Healthy Families Program. It is unclear if claimants would be required to apply for eligibility in the Healthy Families Program to verify their eligibility prior to being allowed the credit. The department would have difficulty verifying that the claimant was "eligible" if the claimant does not actually apply and receive benefits.

The bill defines "eligible amount" as "an amount equal to the amount of the average benefit received during the year preceding the taxable year by a participant in the Healthy Families Program." The department does not have a method to verify the average benefit amount. In addition, it is unclear if the taxpayer must actually have been a participant in the Healthy Families Program in the preceding year.

This bill requires that refunds be paid on a quarterly basis. FTB's current systems are programmed for annual processing and are unable to refund an amount in quarterly installments.

This bill also requires FTB to prescribe forms and an application procedure for this credit. It is unclear what information should be required on the application that would differ from information provided on the tax return. Further, for information that is not required to be provided by the statute but is requested on the application, FTB would be obligated to comply with the provisions of the Administrative Procedures Act and adopt regulations, which may delay FTB's ability to administer this credit on a timely basis.

Clarification is needed of whether the application is to be filed with the tax return, which is filed annually, or if the application would be filed quarterly. If four applications are required (one per quarter), it is unclear if the taxpayer would need to qualify for each quarter separately (i.e., 2 of the 4) or if the taxpayer would need to qualify for all four quarters. In addition, if the application would be filed quarterly a deadline for filing the application would need to be identified.

If the intent is to require the application to be filed with the return, but the application is filed after the first quarter, clarification is needed of whether the first quarter payment would be disallowed or whether the quarters begin when the application is filed. Clarification also would be needed for applications with returns filed late due to automatic extensions.

The bill specifies that the member of the taxpayer's family for whom health insurance is provided must be eligible for the Healthy Families Program. Part of the criteria to qualify for eligibility in the Healthy Families Program requires the applicant to have an annual or monthly household income equal to or less than 250% of the federal poverty level. Most of these taxpayers do not have a state income tax filing requirement, but would be forced to file an income tax return to receive the benefit of the refund provided under this proposed credit.

According to the 2000 U.S. Department of Health and Human Services Federal Poverty Guidelines, the poverty guidelines are sometimes loosely referred to as the "federal poverty level." However, that term is ambiguous and should be avoided in situations (e.g., legislative or administrative) where precision is important. There are no universal administrative definitions of "family," "family unit," or "household" that are valid for all programs that use the poverty guidelines. The absence of a definition that identifies the author's intent complicates the administration of this credit.

The 2000 U.S. Department of Health and Human Services Poverty Guidelines indicate the following (not including Alaska and Hawaii):

Size of Family Unit	48 Contiguous States and D.C.	x 250%
1	\$8,350	\$20,875
2	\$11,250	\$28,125
3	\$14,150	\$35,376
4	\$17,050	\$42,625
5	\$19,950	\$49,875

For each additional person add \$2,900.

Since the "federal poverty level" generally refers to more than one individual, it is unclear how the taxpayer or the department would determine eligibility for the credit. For example, it is unclear how the income of the other members of the household that are not family members would affect the taxpayer's eligibility for the credit.

The department has no ability to verify household or family income. Tax benefits, such as the renters' credit, generally are tied to the AGI amount, with a maximum AGI for qualifying married couples filing a joint return and heads of household and a lower maximum AGI for qualifying single filers.

Administration of the credit may be less difficult if:

- the quarterly application procedure was eliminated;
- applicants were required to actually apply for the Healthy Families Program, rather than just be "eligible;" and
- the Healthy Families Program was required to provide the department with a list of eligible applicants for verification purposes.

This bill would require regular appropriations by the Legislature to pay for the refundable portion of this credit. If sufficient funds were not appropriated to cover all of the refunds due, the department would suspend payment of the refunds until additional funds were appropriated. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

Many individuals eligible for the Healthy Families Program probably have little or no federal or state tax liability and do not have a California filing requirement. Current nonfilers would be required to file tax returns to claim the proposed credit, which would significantly impact the department's programs and costs.

The proposed credit under this bill would be claimed by low-income individuals. Low-income individuals generally file their tax returns on Forms 540A or the postcard-size 540 2EZ. To minimize the complexity of these returns, the only credit allowed on these forms is the nonrefundable renters' credit. The department could not add this proposed credit to the Form 540 2EZ as this form does not accommodate attached schedules due to its size. As a result, taxpayers that would normally file on Form 540 2EZ would be required to file Form 540A to claim the credit.

Since the proposed credit is refundable, the credit would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540 2EZ. This would increase PIT return Forms 540, 540NR, 540X, and potentially the 540A by one page. Adding a page to these forms would result in a significant impact on FTB's operations and costs, would slow return processing, and would increase the amount of return storage space. The department would work within available space to the extent possible but may be required to lease additional office and file storage space to store larger returns and the additional returns generated by this credit.

## **LEGISLATIVE HISTORY**

AB 39 (Thomson and Campbell, 2001/2002) proposes a refundable tax credit to an employer for providing health coverage for certain employees and their dependents, and is currently in the Assembly Revenue and Taxation Committee.

AB 694 (Corbett, 2001/2002) proposes a tax credit for small employers that provide health coverage to their employees, and is currently in the Assembly Revenue and Taxation Committee.

AB 1734 (Thomson, 1999/2000) proposed an employer-provided health insurance premiums refundable credit, and failed passage in Assembly Appropriations.

AB 1262 (Campbell, 1999/2000) proposed an employer-provided health care coverage credit, and failed passage of the Assembly.

AB 1172 (Frusetta, 1999/2000), AB 2520 (Prenter, 1997/1998), and AB 148 (Frusetta, 1997/1998) each proposed an employer provided health care credit for farmworkers, and each failed passage in the first policy committee.

## **OTHER STATES' INFORMATION**

Review of Florida, Illinois, Michigan, Texas, and New York laws found no comparable tax credits to the one proposed in this bill. These states were reviewed because of the similarities between California income tax laws and their tax laws.

## **FISCAL IMPACT**

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved, but are expected to be about \$7 million and in excess of 200 personnel years.

## **ECONOMIC IMPACT**

### Tax Revenue Estimate

Based on very limited data and assumptions discussed below, this bill would result in minor revenue losses initially (less than \$500,000) under the PITL reaching on the order of \$1 million annually beginning in 2003-04.

### Tax Revenue Discussion

The revenue impact of this bill would be determined by the amount of credits reported on tax returns or other application procedure and forms as required.

The number of taxpayers who would report the credit is expected to be very limited. Participation is anticipated to be minimal due to the necessity of taxpayers having to first pay monthly premiums out-of-pocket only to later obtain a refund. Any likely participants would probably be from the group who is eligible but not currently enrolled in Healthy Families Program. It is assumed that those who already participate in the Healthy Families Program would not terminate participation for this proposal.

According to contacts at the managed Risk Medical Insurance Board, the differential between individuals eligible to participate in the Healthy Families Program and those who are actually enrolled is roughly 225,000. Assuming this converts to roughly 130,000 family units or taxpayers, participation is not expected to be significant, perhaps reaching 1% of this group by the third year. Assuming this level of participation and an average annual benefit of \$1,000 would derive credits of \$1.1 million by the third year.

## **ARGUMENTS/POLICY CONCERNS**

This bill may not achieve the author's intent for low-income families to access funds in order to independently purchase health care. The proposed credit would first be used against the taxpayer's tax liability, and then offset against other amounts due, then any remaining amount would be refunded to the taxpayer. There is an assumption reflected here that federal money from the Healthy Families Program would be available to fund the refundable portion of this credit. Unless there is clear federal authority to support that conclusion, this bill may not be able to accomplish this purpose.

Historically, refundable credits such as the prior state renter's credit and the federal Earned Income Credit have had significant problems with invalid and fraudulent returns. These problems are aggravated if a refund is made that is later determined to be fraudulent since the refund commonly cannot be recovered.

## **LEGISLATIVE STAFF CONTACT**

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